Azerbaijan

Set against impressive economic growth, which will continue as large oil sector investments begin production, rising inflation highlighted the underlying sensitivity of the macroeconomic environment. The Government should, though, take advantage of this prosperity to institute the necessary structural changes that will sustain strong performance and enhance welfare over the longer term.

Macroeconomic assessment of 2004

In line with the 10.7% average annual growth of the past 5 years, GDP grew by 10.2% in 2004. Progress in foreign capital investments in the oil and gas sector—namely the Baku-Tbilisi-Ceyhan (BTC) oil pipeline, the Azeri-Chirag-Gunashli (ACG) oil fields, and the Shah-Deniz gas field and pipeline—provided the stimulus for the overall outcome. Industry, up by 12.2%, accounted for 62% of the GDP increase, with construction expanding by nearly 42%. Construction has benefited from the oil sector investments, as well as from a building boom in the capital and from foreign-funded infrastructure projects, and has more than quadrupled in size during the last 3 years. Despite agriculture's importance as an employer—accounting for nearly 40% of total employment—its 4.6% rise contributed only 5.9% to total GDP growth. Services expanded by 7.7%, reflecting mainly an upsurge in communications and trade.

Official unemployment remained low in 2004 at 1.5%, but this figure includes only individuals registered for unemployment assistance. The State Statistical Committee carried out a labor force survey in 2003 (following international standards), showing unemployment at 10.7%, with the urban rate double that of rural areas (14.0% versus 7.0%). Women suffered higher rates than men (12.2% versus 9.6%).

According to the latest figures from the 2002 household budget survey, nearly half of the population is living in poverty, based on monthly minimum consumption needs of food and nonfood items of AZM175,000 ($36) per person. Urban areas suffered somewhat higher rates than rural areas; this atypical outcome stems from the fact that the camps of internally displaced persons are located in urban areas.

In 2004, the Government continued to pursue a prudent fiscal policy. Revenues and grants were 25.0% of GDP, with VAT the main source of funds. Government spending reached 27.0% of GDP, partly stemming from increases in wages and energy subsidies. The overall deficit at 2.0% of GDP was somewhat less than in 2003. While small deficits have kept national debt levels low, the limited supply of treasury bills has created difficulties in managing the money supply.

Although high world oil prices in 2004 had a beneficial impact on growth and fiscal performance, price stability suffered. The efforts of the National Bank of Azerbaijan (NBAR) to avoid a nominal appreciation of the exchange rate, coupled with the thin treasury bill market, led to an unsterilized accumulation of foreign assets and a rapid expansion of the money supply. Although NBAR began in August to issue its own bonds to absorb liquidity, broad money still jumped by 47.5% over the year. Moreover, increases in some administered prices—notably retail prices for fuel—further aggravated inflation. By December, consumer prices were 10.5% higher than at end-2003, and average annual inflation for 2004 reached 6.7% (Figure 2.21). Although NBAR's intervention efforts succeeded, with the average exchange rate against the dollar remaining essentially unchanged over the year, the real exchange rate appreciated somewhat because of the inflation differential.

Buoyant oil sector developments were reflected in the balance of payments as well. Exports grew by 31.5%, triggered by high world oil prices, such that the level of exports was nearly $3.5 billion, or 40.5% of GDP. Investment activities led to a rapid 25.2% expansion of imports, with the result that the level of imports was on a par with exports at 40% of GDP. While the trade account was virtually balanced, an increase in the large net services and income deficit (primarily associated with the oil sector) widened the current account deficit to 30.7% of GDP in 2004 from 28.3% a year earlier. As in recent years, net capital inflows, mainly FDI, exceeded the current account deficit and international reserves (including the oil fund) climbed by $284 million.

Table 2.19 Major economic indicators, Azerbaijan, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	10.2	14.5	19.0	22.0
GDI/GDP	40.0	35.0	30.0	30.0
Inflation (CPI)	6.7	5.5	4.5	4.0
Money supply (M2) growth	47.5	31.0	35.0	38.0
Fiscal balance/GDP	-2.0	-1.1	-1.0	-1.0
Merchandise export growth	31.5	24.5	50.5	45.0
Merchandise import growth	25.2	7.5	-2.5	-5.0
Current account/GDP	-30.7	-20.0	-6.0	4.5

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product.

Sources: Ministry of Finance; National Bank of Azerbaijan; State Statistical Committee of Azerbaijan Republic; International Monetary Fund; staff estimates.

Macroeconomic policy developments

In November 2004, Parliament approved the 2005 budget, the first budget to be consistent with the Government's new long-term strategy on the management of oil revenues. This strategy appropriately provides for annual limits on the change in the non-oil deficit to guide fiscal policy. The budget targets a fiscal deficit of AZM579 billion (1.2% of GDP), using a projected world oil price of $25 per barrel in its calculations. Even accounting for the discount on the price of Azerbaijan's oil relative to Brent crude, on the assumption of higher prices it is likely that the budget deficit will be smaller than targeted, regardless of whether retail prices are adjusted to restrict the increase in the budgeted cost of domestic oil subsidies.

NBAR's stated policy target is inflation, but exchange rate management dominated actions in 2004. Remonetization of the economy has enabled the rapid money supply growth of recent years to be absorbed without it putting excessive pressure on the price level, but the reemergence of inflation in 2004 clearly shows that there are limits to this "inflation-free" monetary expansion. Since success in achieving inflation targets affects people's willingness to hold the local currency, the introduction of central bank bills gives NBAR a valuable tool to maintain price stability. Managing large foreign exchange inflows generated by the oil sector is a key policy challenge over the medium term.

The Government took several important steps in reforming the financial sector. In January 2004, it adopted the Banking System Law that is consistent with the Basle Core Principles, thereby fostering better corporate governance at commercial banks. Moreover, the law creates a level playing field by applying prudential requirements consistently across all financial institutions. In December 2004, the National Bank Law was enacted. This gives NBAR considerable independence to pursue monetary policy, but also holds it accountable for results. It also includes measures to improve the transparency of NBAR's operations.

Outlook for 2005–2007 and medium-term trends

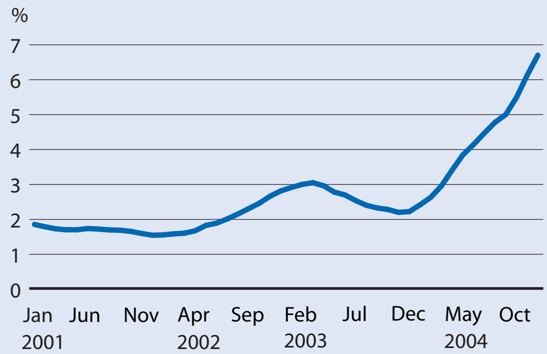
The medium-term outlook for the economy is very positive, with the main driving force switching from investments in the oil sector to resultant production and export. The BTC pipeline should become operational by September 2005. The first phase of the ACG oil fields began production during the first quarter of 2005. Although the BTC investment is winding down, the Shah-Deniz gas field and its pipeline, plus further development of the ACG oil fields, will ensure that investment and construction remain dynamic. Additionally, the Government has announced its intention to rehabilitate completely the east-west and north-south road corridors in the coming years. Moreover, NBAR will continue to resist undue real exchange rate appreciation to assist development of the non-oil sector, so as to avoid the deleterious effects of "Dutch disease." Accordingly, the outlook is for GDP growth to accelerate to 14.5% in 2005, rising further to 19.0% in 2006 and 22.0% in 2007.

The authorities are expected to continue to pursue prudent fiscal and monetary policies over the medium term. Fiscal policy plans are consistent with the sustainable use of oil wealth, as laid out in the Government's long-term strategy on the management of oil revenues. For 2005, the Government is targeting a non-oil deficit of 16.8% of non-oil GDP that will rise to 18.7% by 2007, and the *ADO 2005* budget projections assume that these targets will be attained. With no major declines in world oil prices expected, the projected overall deficits of less than 2% of GDP should be met, even accounting for wage and pension increases planned for 2005 and the ambitious public investment program.

With greater foreign exchange inflows from the oil sector, NBAR will face challenges in balancing price and exchange rate stability. NBAR is targeting an inflation rate of 5% in 2005 and 2–3% in 2006–2007, but this will be difficult to achieve without some appreciation of the exchange rate. *ADO 2005* forecasts a somewhat higher rate of 5.5% in 2005, slowing to 4.0% by 2007.

The changing pattern of investment and hydrocarbon production will be seen in balance-of-payments developments. Export growth will accelerate sharply in 2006, as the first two phases of the ACG oil fields begin production, and moderate only slightly in 2007. Import growth, in contrast, will decline in 2005 as investment in the BTC pipeline and much of the work on the ACG oil fields is completed. Gas production from the Shah-Deniz field should begin in 2006, displacing some of the gas imports (and contributing to export growth). As incomes improve, growth in imports of consumer goods will offset part of the decline in capital goods imports, though total imports are projected to fall slightly in 2006–2007. Despite the fact that factor income outflows will rise as oil profits are repatriated, the current account will swing from a large deficit of 30.7% of GDP in 2004 to a surplus of 4.5% in 2007.

Figure 2.21 12-month moving average inflation rate, Azerbaijan, January 2001–December 2004



Source: State Statistical Committee of Azerbaijan Republic.

Growth in the non-oil sector hinges on progress in the structural reform agenda. Even though reform of the two state-owned commercial banks needs to be accelerated to create a truly competitive financial sector, policy changes in the sector mark a beginning—but more work is required to foster an economy with a diverse production base. Governance reforms, including enforcement of the anticorruption law passed in January 2004 and simplification of the bureaucratic requirements for businesses, are needed. Encouragingly, negotiations on the settlement of issues from the Nagorno-Karabakh conflict have shown some recent positive signs, and concrete progress would further enhance growth prospects.